

CENTRAL ILLINOIS LIGHT COMPANY

**Docket No. 02-0837, CILCO Gas Rate Case
Response to Staff Data Requests FIN-50 through FIN-68**

FIN-54: Beginning on line 225, Dr. Lesser asserts that Ms. Phipps' Direct Testimony, at lines 342-349, implies that a previous day's stock price may have been the "correct" price with which to calculate a COE value.

- a. Provide a citation to Ms. Phipps' Direct Testimony in which she refers to a "correct" stock price or otherwise describes stock prices as being "correct" or a synonym of "correct."**
- b. Define "correct price" as Dr. Lesser uses the phrase in his testimony cited above. Does "correct price" refer to a stock price's intrinsic value? Does "correct price" refer to a stock price's value as investors perceive it?**

Response:

- a. Please see the discussion in Phipps, lines 349-351. Ms. Phipps uses the word "inaccurate" to describe the use of historic stock prices. Dr. Lesser assumed that "inaccurate" was synonymous with "incorrect." Since Ms. Phipps stated that the use of historic prices was "inaccurate" or "incorrect," Dr. Lesser assumed that the use of current stock prices would be "accurate" or, synonymously, "correct."
- b. The question is unclear, since the nature of the term "intrinsic price" is not specified. With that qualification, Dr. Lesser provides the following response: Dr. Lesser agrees that investor perceptions determine stock prices. However, such perceptions may be based on inaccurate information, as some of the more recent accounting scandals appear to indicate.

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ILL. C. C. DOCKET NO. 02-0837

CILCO Cross EXHIBIT No. 1

Witness _____

Date 6/11/03 Reporter CB

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FIN-55: Beginning on line 230, Dr. Lesser states, "Second, Ms. Phipps argues that stock prices change with the approach of a dividend payment date. In addition to being unfounded (stock prices, after all, change all the time), if one accepts her statement as true, then the EMH (as Ms. Phipps describes it) cannot hold, because the EMH means that stock price changes cannot be accurately predicted." Is Dr. Lesser suggesting that the timing of dividend payments have [sic] no effect on stock price? If so, provide the basis for this statement including published academic books, articles, studies or papers. Additionally, cite the portions of Ms. Phipps' Direct Testimony that state dividend payment information allows investors to accurately predict stock price changes.

Response: Dr. Lesser has not performed empirical research as to the effects of forthcoming dividend payments on stock prices. He is making no such suggestion. Furthermore, Dr. Lesser's testimony refers to his interpretation of Ms. Phipps's testimony and her discussion of the EMH therein.

The definition of "accurate" with regard to the prediction of stock price changes is unclear. With that qualification, Dr. Lesser interpreted Ms. Phipps's testimony as an admission that stock prices change in a manner that is measurably different from the stochastic "random walk" behavior (technically known as geometric Brownian motion) normally attributed to stock price changes. If Ms. Phipps meant that, as a dividend payment date approaches, the pattern of stock price changes continue to exhibit this same stochastic behavior, then Dr. Lesser would agree that stock prices cannot be accurately predicted. However, such a conclusion necessarily implies that the statements made by Ms. Phipps's in her direct testimony [Direct at 16, lines 342-349] are contradictory, as discussed by Dr. Lesser in his rebuttal testimony.

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FIN-59: Provide documentation supporting Dr. Lesser's statement that "historical data can be a useful guide in determining whether current conditions are aberrant." (See lines 488-491.) Specifically, provide source documents that indicate one can predict future earnings growth rates and interest rates using historical data.

Response: Dr. Lesser was not relying on any specific documents. Rather, his statement is based on many years' study of, and experience with, econometric and time series modeling and forecasting models.

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FIN-63: Beginning on line 661, Dr. Lesser states, "What Ms. Phipps has done in her 'proof' is to take the RP assumption of an equity risk premium over the cost of debt and fold it into the CAPM." Explain Dr. Lesser's statement further. Please provide a detailed explanation of how the CAPM differs from the RP model.

Response: Ms. Phipps substituted the rate of return on corporate bonds for the risk-free rate in the CAPM. Since the rate of return on bonds will be greater than the risk-free rate, the calculated expected rate of return on the specific asset will be greater than the calculated rate using a risk-free rate, as long as the asset's beta is less than one. This is the essence of Ms. Phipps's "proof."

A detailed discussion of the RP model can be found in R. Morin, Regulatory Finance: Utilities Cost of Capital, PUR Press, 1994, Chapter 11. See also, E. Brigham, et al., "The Risk premium Approach to Measuring a Utility's Cost of Capital," Financial Management, Spring 1985, pp. 33-45. Additionally, see Ibbotson Associates, Stocks, Bonds, Bills, and Inflation, 2003 Yearbook, Valuation Edition, March 2003, Chapter 5.

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Response to Staff Data Requests FIN-69 through FIN-73**

FIN-70: Beginning on line 242 of CILCO Rebuttal Exhibit 7.10, Dr. Lesser addresses the future dividend payment assumption in Staff's DCF model. Does Dr. Lesser believe that any of the companies in Staff's sample is likely to raise its dividend payment more frequently than once per year? If so, provide supporting documentation for Dr. Lesser's viewpoint, including published academic books, articles, studies or papers. In the response, identify the dates on which each company in Staff's sample raised its dividend during the last five years.

Response: Dr. Lesser agrees that the comparable companies probably do not adjust their dividends more than annually. As he explained in his testimony, however, that is immaterial to the calculations made using the quarterly DCF model. The quarters in which the individual companies adjusted their dividend payments can be determined by reviewing the individual company Value Line Investment Survey Reports. These were previously provided as and exhibit to Dr. Lesser's direct testimony.

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